



Submission to the US Treasury Advisory Committee on the Auditing Profession

Aon or its predecessor firms have acted as brokers and advisors to the US accounting profession for more than 70 years. Currently, Aon provides professional liability broking and/or consulting services to 43 of the 100 largest accounting firms carrying out business in the United States.

As a member of the executive committee of Aon Global – Professions Practice, I have had the pleasure of being associated with large and mid-sized accounting firms for more than twenty years, working with them to help identify, manage and finance the costs of their professional risks.

The Committee has had considerable and sometimes conflicting input in terms of what to say and do regarding the legal liability risks facing accounting firms. Therefore, I believe it is important for me to be clear in terms of my professional perspective.

I want you to know that at no time have we encountered a situation in which there existed as substantial a threat to the continued viability and sustainability of the audit firms as that created today by the potential for mega professional liability claims brought in US courts.

Let me step back and observe that we have read with interest the Firm Structure and Finances section of the Advisory Committee's May 5 Draft Report and we wish to express our support for various ideas set out in this section, specifically, positive initiatives such as sharing best practices and working toward better corporate governance of firms.

The Concentration and Competition section of the Draft Report does observe the threat of civil litigation as being real and it notes a concern for market disruptions that would result at the loss of another firm. While the Draft Report does include recommendations for a mechanism that could be brought to bear if a firm was in peril, it isn't clear in terms of exactly what is intended and this leaves some uncertainty about the direction in which the Committee may be moving or exactly what it is urging others to do.

We are concerned, and believe the members of the Committee should be concerned, with the lack of more pointed commentary on the need for timely action by policymakers to address the unlimited nature of financial risk that firms face from civil litigation. And I can assure you that the unlimited nature of this liability is uninsured.

We note that, in a preliminary document released April 1, the Firm Structure and Finances Subcommittee said it had considered the liability issues impacting the profession. This document noted that the Advisory Committee has received submissions regarding the possibility of audit firms experiencing catastrophic losses from legal claims. The Committee has also received recommendations for a variety of potential solutions to this liability issue. Further, it has received statements of opposition to these recommendations to further limit auditor liability. The May 5 Draft Report notes that the Committee's work is incomplete and that it is considering and debating a variety of other issues. So, what do we really know at this point? Not very much.

Our concern, in reviewing the Draft Report, is that one could infer that the Committee – or the Subcommittee – believes that a combination of best practices, corporate governance, and other similar initiatives, may go much of the way toward addressing the danger of another large accounting firm being lost due to a catastrophic liability claim. On the other hand, the Committee may simply be addressing those issues on which it is easiest to achieve consensus – before tackling more controversial issues. However, we feel that limitation of liability measures are a necessary part of any strategy to address the danger of loss of another firm – and that such measures must be dealt with as an integral part of any reform strategy, not as an afterthought.

We note, for example, that one of the recommendations in the Firm Structure and Finances section of the March 5 Draft Report calls upon various parties to analyze, explore, and enable, as appropriate, the possibility and feasibility of firms appointing independent members with full voting power to firm boards and/or advisory boards with meaningful governance responsibilities to improve the governance and transparency at auditing firms. In making this recommendation, the Committee acknowledges, in passing, that any exploration of this idea would necessarily touch upon liability concerns. Indeed, without some assurance that liability protection can be provided, it would surely be unlikely that persons of sufficient stature, reputation, and capabilities could be easily persuaded to accept such appointments. Yet, in urging the SEC and PCAOB to enable the appointment of outsiders to firm boards, the Draft Report calls for them to do so “within the current context of independence requirements and the liability regime.”

We find this “within the current context” restriction to run counter to the apparent objective of enabling outsiders to serve on firm boards. Similarly, we find the seeming hesitancy by the Committee to speak unequivocally and emphatically about the unlimited liability threat to run counter to the Committee’s efforts to address the long-term sustainability of private sector auditing.

Aon’s views have been set forth in detailed papers submitted as part of a larger package of material provided to this Committee by the major public company audit firms. In essence, we have addressed the so-called “insurability” issue impacting large accounting firms. We have provided background information on the inability of the commercial insurance market to supply necessary coverage – sufficient for large firm’s needs – at a reasonable price. We trust that you have examined this material – and perhaps may have some questions for me today.

In the short time available to me, I would like to briefly review a few of the highlights of these papers – and provide a little additional information. I think the best way to do so is to hone in on what may be the more contentious points at issue – those on which the Committee has already heard opposing arguments.

More specifically, one witness who has appeared before the Committee maintains that the view that top firms cannot get commercial insurance sufficient for all their needs is not well documented and is often coupled with the observation that firms use (or “must use”) captive affiliates to provide insurance. This witness has suggested that firms may, in fact, opt for such self-insurance “simply because they are better than external insurers at assessing and managing risk and evaluating and administering claims.” Let me set the record straight. The captives in question were formed in direct response to the inability of the commercial insurance market to supply necessary coverage at a reasonable price. From a financial management perspective, such captives are usually viewed negatively, because capital committed to the captive reduces capital that would probably be used more profitably elsewhere within the member firm, for example, to hire additional auditors.

The same witness has argued that there is evidence that insurers offer, and firms buy, external insurance, to reinsure claims managed and funded through firm captives. In response, I would like to point out that, currently, the commercial insurance and reinsurance markets provide only a very small part of the risk financing solution needed by the audit profession. More financially attractive underwriting opportunities exist elsewhere and have led many insurers to abandon the market. This market abandonment by many insurers has resulted in a severely constricted professional indemnity commercial risk transfer market, which is characterized by high mandatory retentions, insufficient limits of liability and high prices. While captives have provided a modicum of relief, their relatively small capital base makes it impossible for them to replace the capacity lost by insurers' decisions to exit this market.

On another point, it has also been argued, before this Committee, that even if it can be established that available commercial insurance is currently insufficient for firms' needs, it is not obvious that defects in the liability system are the cause of this situation.

Let me say, in regard to this point, that looking at large firms and their liability risks, insurers need to have an ability to accurately define the risks that can lead to insurable losses. In respect to liability insurance, there must be some degree of certainty attached to what may be considered a negligent act. As you are well aware by this point in your deliberations, there is no single right answer to many auditing/accounting issues, the questions are complex and require judgment. Auditor litigation almost invariably involves the assessment in hindsight of whether the auditor's exercise in judgment was reasonable or unreasonable. There are unlikely to be simple points of delineation between two views and thus there will be a contest among "experts" to determine which side of the litigation fence was "right".

As we stress in one of the detailed papers that has been made available to you, only when there can be greater certainty as to the nature of the risk facing the profession will commercial insurers be attracted once again to offer a stable form of insurance protection that better protects the firms against the risk of loss.

I hope I've been able to briefly address some of the points that may perhaps still be at issue for Committee members and, in so doing, have helped to advance your deliberations.

Assuming the Committee is in agreement on the importance of private sector public company auditing to the capital markets, investors and the economy, I urge you to be unequivocal and emphatic on the need for policymakers to address the unlimited nature of litigation risk. As I stated at the outset, at no time have we encountered a situation in which there existed as substantial a threat to the continued viability and sustainability of the audit firms as that created today by the potential for mega professional liability claims brought in US courts.

If you wish to have additional information from us on any of the topics covered during the Committee's June 3 meeting, or in regard to any Aon Global papers that have been submitted to the Committee, we will most certainly undertake to provide it.